

Microeconomics for Managers

This fully updated fourth edition explores microeconomic concepts, with a distinctive emphasis on the “economic way of thinking” and its applicability to sharp managerial thinking, productivity, and good decision-making. It stands apart due to its strong focus on practical and applied knowledge from the business context and its unique structure (Part A of each chapter develops key economic principles; Part B draws on those principles to discuss organizational and incentive issues in management, focusing on solving the “principal–agent” problem to maximize the profitability of the firm). There are plentiful real-life scenarios and provocative examples in each chapter. Accessible to MBA students, other graduate students, and undergraduates, it is ideal as a core text for courses in managerial economics. Requiring an understanding of only basic algebra, this new edition is more concise, with a wealth of online resources, including additional online chapters and an online appendix with more-advanced mathematical applications.

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Microeconomics for Managers

Principles and Applications

Fourth Edition

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The Further Readings are all available on the Cambridge online resources website www.cambridge.org/mckenzie4 as files and (in the case of those with an external source marked in brackets) as links.

- 1.1 The economics of suspense (*The New York Times*)
- 1.2 The cost of paying attention (*The New York Times*)
- 1.3 Disincentives in poverty relief
- 1.4 Game theory says Pete Carroll's call at goal line is defensible (*The New York Times*)
- 1.5 In Greek debt puzzle, the game theorists have it (*The New York Times*)
- 2.1 Marriages, mistresses, and marginalism (Foundation for Economic Education)
- 2.2 Management snooping
- 2.3 Risk-taking, risk aversion, and firm ownership
- 3.1 Putting a price on Simon Kuznets's Nobel Prize in Economics (*The New York Times*)
- 3.2 Manhattan area codes multiply, but the original 212 is still coveted (*The New York Times*)
- 3.3 The use of knowledge in society (The Library of Economics and Liberty)
- 3.4 Price competition in the short run and the long run
- 3.5 The upside of waiting in line (*The New York Times*)
- 4.1 Covering relocation costs of new hires
- 4.2 For *New York Times*, a gamble on giveaways (*The Wall Street Journal*)
- 5.1 Your contribution to the California drought (*The New York Times*)
- 5.2 They clapped: Can price-gouging laws prohibit scarcity? (The Library of Economics and Liberty)
- 5.3 The right minimum wage: \$0.00 (*The New York Times*)
- 5.4 A \$15 minimum wage bombshell in Los Angeles (*The New York Times*)
- 5.5 Key econometric findings on the effects of the minimum wage
- 5.6 Driving the lemon myth off the lot (Fox News)
- 6.1 Why walking to work can be more polluting than driving to work
- 6.2 Pedophiles and the regulation of hugging
- 6.3 The government nobody knows – nor wants to know (*The Independent Review*)

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- 6.4 Why businessmen are more honest than preachers, politicians, and professors (*The Independent Review*)
- 6.5 The cases for and against free trade
- 6.6 The travels of a T-shirt in a global economy
- 7.1 Why good managers are so rare (*Harvard Business Review*)
- 7.2 Cutting health insurance costs through medical savings accounts
- 9.1 Contestable markets
- 9.2 Wanted: entrepreneurs (Federal Reserve Bank of Minneapolis)
- 9.3 Political entrepreneurs are crowding out the entrepreneurs (RealClearMarkets.com)
- 10.1 The Microsoft monopoly
- 10.2 The “endowment effect” and pricing
- 10.3 In defense of monopoly (*Regulation*)
- 11.1 The value of “mistreating” customers
- 11.2 The special case for regulating banking
- 11.3 At Kodak, clinging to a future beyond film (*The New York Times*)
- 11.4 Hostile takeover defenses
- 11.5 Antitrust laws in the United States
- 11.6 Why economics has been fruitful for strategy (Scribd)
- 12.1 Incentives in the Irvine Company rental contracts
- [Online Chapter 1](#) Behavioral economics
- [Online Chapter 2](#) The environment and environmental policies
- [Online Chapter 3](#) International trade and finance
- [Online Chapter 4](#) A primer on macroeconomics
- [Online Math Appendix](#)

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Recommended Videos Online

The videos marked with minutes are lectures by Richard McKenzie; the other videos are supplemental. The lectures and, in the case of the supplementary videos, the links are available on the Cambridge online resources website www.cambridge.org/mckenzie4.

1 Microeconomics: A Way of Thinking about Business

- 1 Video course introduction (17 minutes)
- 2 Introduction to the economic way of thinking, 1 (28 minutes)
- 3 The economic way of thinking, 2 (29 minutes)
- 4 Property rights, markets, and tragedies of the commons (33 minutes)
- 5 Prisoner's Dilemma (28 minutes)
- 6 Comparative advantage (21 minutes)
- 7 Tragedies of the anticommons (18 minutes)

2 Principles of Rational Behavior in Society and Business

- 1 Rational behavior and the law of demand (31 minutes)
- 2 Rational behavior, continued (26 minutes)

3 Competitive Product Markets and Firm Decisions

- 1 Supply and demand (33 minutes)
- 2 Market efficiency (26 minutes)
- 3 Adding features to products (32 minutes)
- 4 The logic of queues, 1 (24 minutes)
- 5 The logic of queues, 2 (25 minutes)
- 6 Executive pay and overpayment (33 minutes)
- 7 Both Curves; Shifts in Supply and Demand; Supply; Demand; Surplus (Marginal Revolution University @ Practice.MRU.org/)

4 Consumer Choice and Demand in Traditional and Network Markets

- 1 Elasticity of demand (29 minutes)
- 2 Rational addiction (21 minutes)
- 3 Network effects (27 minutes)
- 4 Trust me (Freakonomics.com #266)
- 5 How Airbnb designs for trust (Joe Gebbia; TED talks)

xxii List of Recommended Videos Online

5 Applications of Demand and Supply to Government and Management Policies

- 1 Taxes, subsidies, and prostitution (30 minutes)
- 2 Rent controls (25 minutes)
- 3 Minimum wages (27 minutes)
- 4 Adding fringe benefits (29 minutes)
- 5 Maslow's "Hierarchy of Needs" (21 minutes)
- 6 Incentives, trust, and welfare (25 minutes)
- 7 Leverage and moral hazard (16 minutes)
- 8 The lemon problem (19 minutes)
- 9 The true story of the minimum-wage fight (Freakonomics.com #460)
- 10 What you don't know about online dating (Freakonomics.com #154)
- 11 Price Ceilings; Price Floors (Marginal Revolution University @ Practice.MRU.org/)

6 Principles of Political Economy for Public Policy and Business

- 1 External costs and pollution rights (37 minutes)
- 2 External benefits (24 minutes)
- 3 International trade and protection (32 minutes)
- 4 Government employees gone wild (Freakonomics.com #134)
- 5 Tariffs; Trade; Winners And Losers (Marginal Revolution University @ Practice.MRU.org/)
- 6 What capitalism gets right – and governments get wrong (Katherine Mangu-Ward; TED talks)
- 7 San Francisco's Happy Meal ban (*The Daily Show*)
- 8 Traffic (*The Guardian*)

7 Production, Costs, and the Theory of the Firm

- 1 Principal-agent problems (35 minutes)
- 2 Academic tenure (12 minutes)
- 3 Firms and coordinating costs (27 minutes)
- 4 Make-or-buy decisions (27 minutes)
- 5 Franchising (16 minutes)
- 6 How much does a good boss really matter? (Freakonomics.com #107)
- 7 Why are there so many bad bosses? (Freakonomics.com #495)
- 8 TED-Ed: These companies with no CEO are thriving (TED talks)

8 Production Costs in the Short Run and Long Run

- 1 Short-run cost structures (33 minutes)
- 2 Long-run cost structures (27 minutes)

List of Recommended Videos Online

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9 Firm Production under Idealized Competitive Conditions

- 1 Production under perfect competition (31 minutes)
- 2 Contestable markets (8 minutes)
- 3 The first-mover advantage? (12 minutes)
- 4 The call of the entrepreneur (The Acton Institute)

10 Monopoly Power and Firm Pricing Decisions

- 1 Production and pricing under pure monopoly (32 minutes)
- 2 Problems with monopoly theory (30 minutes)
- 3 Perfect and imperfect price discrimination (29 minutes)
- 4 Market segmentation (25 minutes)

11 Firm Strategy under Imperfectly Competitive Market Conditions

- 1 Monopolistic competition (27 minutes)
- 2 Oligopoly and cartels (34 minutes)
- 3 Natural monopoly (20 minutes)
- 4 Taxation and regulation of monopoly (23 minutes)
- 5 The innovator's dilemma (36 minutes)
- 6 Comedic/cynical on outsourcing (Despair.com)

12 Competitive and Monopsonistic Labor Markets

- 1 Intro to labor markets (35 minutes)
- 2 Competitive labor markets (37 minutes)
- 3 Monopsony labor markets (32 minutes)
- 4 Labor market discrimination (25 minutes)
- 5 Menu of two-part pay options (12 minutes)
- 6 Relocating workers and two-part pay (16 minutes)
- 7 A cheap employee is ... a cheap employee (Freakonomics.com #79)
- 8 Why does the most monotonous job in the world pay \$1 million? (Freakonomics.com #493)
- 9 The true story of the gender pay gap (Freakonomics.com #232)
- 10 What can Uber teach us about the gender pay gap? (Freakonomics.com #317)
- 11 Learning from dirty jobs (Mike Rowe; TED talks)
- 12 Working stiffed (*The Daily Show*)

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Preface for Teachers

The man who solves complex problems in the space of five minutes on the intuitive basis of “sound” ... judgment [may] sleep easily at night while the analyst who devoted two years to the same topic may sleep badly, but only because he has become acutely aware of all the pitfalls in the problem.

Malcolm Hoag¹

Most textbooks used in a microeconomics course for graduate business students – and in a second microeconomics course for undergraduate business students – are designed with undergraduate economics *majors* (or first-year Ph.D. economics students) in mind. Accordingly, business students are often treated to a conventional course in intermediate microeconomic theory, full of arcane mathematical explanations. The applications in such textbooks deal primarily with the impact of government policies on markets. There is little discussion about real-world managers using microeconomics to make better decisions in response to market forces – or how market forces can be expected to affect the structure of firms. These textbooks pay scant attention to the *economic way of thinking* (which differs dramatically from how other professors think about business issues) and what it offers managers – a way to improve their thinking and decision-making on enhancing profits or achieving other organizational goals.

This is because much microeconomic theory simply assumes firms into existence, with little or nothing about why they are needed in the first place. Moreover, managers and their staff are assumed to do exactly what they are employed to do (e.g., maximize owner profits) with little discussion of how organizational and financial structures affect incentives – and how incentives affect production and profit outcomes. And managers are presumed to think through business problems and make decisions with great (even perfect) care and precision – a premise that leaves less room for teaching students how they can improve their thinking and decision-making.

¹ *The Worlds of Herman Kahn: The Intuitive Science of Thermonuclear War* by Sharon Ghamari-Tabrizi, Cambridge, Mass.: Harvard University Press, Copyright © 2005 by the President and Fellows of Harvard College. Used by permission. All rights reserved.

xxvi Preface for Teachers

These deficiencies are a problem for serious business students: They typically attend business schools to improve their management skills and learn how to enhance their ability to extract more productivity and profit from the scarce resources available to their firms. They do not want to become economic theorists. As such, *Microeconomics for Managers* breaks from the standard textbook mold. As the title suggests, we have designed this textbook for (future) managers in graduate and undergraduate programs.

The Organization of the Book

In Part A of every chapter, we cover standard microeconomic theory in an accessible way. (We have more technical details in an Online Math Appendix for those who are interested.) Microeconomics adds much to an understanding of firms, consumers, and markets. Such knowledge is valuable – and professors in other business fields will expect their students to have a firm grounding in conventional microeconomic theory. We also provide an array of applications to government policies that business students should understand. After all, managers everywhere face the constraints of government-imposed laws and regulations – and must work to maximize profits within those constraints.

In Part B of every chapter, we go where other microeconomics textbooks seldom, if ever, go with much depth. We drop the usual assumption that firms magically come into existence and automatically maximize profits by simply following maximization rules. Instead, we directly address crucial problems that pervade management decision-making. For example, the “principal–agent problem” is that both owners and workers are more interested in pursuing their own well-being. Owners (“principals”) want to maximize their income streams and wealth through the firms they create by getting the most from their employees. Managers and other employees (“agents” of the owner) seek to maximize some combination of income, perks, and job security, which are often in conflict with maximizing profits for the owners. Without effective firm policies that align the incentives of owners and workers for their *mutual benefit*, the work in a firm can be a self-destructive tug of war, with the demise of the firm virtually assured (especially in more-competitive markets).

Getting hourly and monthly pay systems right is obviously an important means of aligning the interests of owners and managers. However, we also explain how the structure of firms, in terms of both people and finances, can affect owner and worker incentives. And make no mistake: both owners and their employees have a stake in finding the right alignment. Jobs can hang in the balance. A firm’s ability to thrive and even survive can be greatly impacted by a cost-effective alignment of incentives. As such, we focus student attention on thinking through the complex problems of getting incentives right. *There is as much (maybe more) profit to be made from creatively structuring incentives (and prices) as from developing and marketing products for sale.*

Preface for Teachers

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Accordingly, this book places a great deal of emphasis on an increasingly important field within economics, especially as the subject relates to the business world and business programs: *organizational economics* – the study of the design of organizational and financial structures in firms, using the analytical tools of microeconomic analysis. The mode of thinking presented in these pages is crucial for managers who want to ascend their corporate hierarchy or create successful companies of their own. Many of these topics are covered in *organizational behavior* courses which are grounded in psychology. With the economic approach developed here, students will understand how business topics can be approached from different disciplinary perspectives, often with complementary insights.

In between Parts A and B of every chapter, we have inserted a “Perspective” – a short section that provides a novel take on a business or policy issue. For example, everyone *knows* (don’t they?) that the “first mover” in any market has a competitive advantage. But in Perspective 9 for Chapter 9, we discuss a startling research finding made by management scholars: there is no “first-mover advantage” (or it appears rarely). First movers can even be at a decided disadvantage, which explains why so many well-known firms that dominate their industries today were “followers.”

Many authors and their publishers play textbook development “safe” by taking up only those topics that have become fixtures in the profession’s “conventional wisdom.” Such an approach sucks the life out of a discipline and its textbook treatments. Topics that have not yet been fully settled by decades of professional debate can give life to a discipline by showing students how disciplines have an organic quality, in that they are constantly evolving through debate. As a consequence, you can expect many topics in this book to spark lively and constructive discussions among students and professors. This is how we want the book to be received.

Toward the end of each chapter, we insert a short series of “Practical Lessons” which are designed to show how the concepts in each chapter can help managers solve workplace problems – all with an eye toward enhancing firm profitability (or the achievement of other firm goals). We believe that theory at its best is a guide to improved thinking, decision-making, and profitability – as well as welfare gains for consumers, workers, owners, and society. Each chapter also has a section titled “The bottom line” – a list of *key takeaways* or succinct statements of the most important points to be drawn from the chapter.

The scholarly and policy literature in economics and management related to most of the topics considered in this volume is massive. We have tried to give credit where credit is due, especially where “classic” or seminal treatments are concerned. However, we have tried to limit references and footnotes so the flow of the argument is not constantly disrupted. Given space constraints, we have a modest select bibliography at the end of the book, but a full bibliography online.